Asset Allocation is a Diversification Strategy

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As fiduciaries, state and local government employers are responsible for the adequacy and appropriateness of the investment options that are included in their defined contribution and deferred compensation plans. This responsibility can be assigned to a board or committee, internal staff, or contract service provider, such as a third party administrator or consultant.

Because fiduciary responsibility cannot be completely delegated, employers should have a basic understanding of diversification and asset allocation, and how it can help investors minimize risk, to allow them to evaluate the adequacy of their plan's investment menu. This is true even if selecting and monitoring investments are completely outsourced and assigned to a contract service provider.

This brochure has been prepared to discuss:

- ✓ why diversification and asset allocation are important in defined contribution plans
- ✓ what are the asset classes generally used in defined contribution plans
- ✓ what employers should do to promote asset allocation in participant accounts
- ✓ current trends in defined contribution plans

<u>Diversification versus Asset Allocation</u>

The phrase "don't put all your eggs in one basket" is often used as an illustration of diversification. Having all investments in a single security or issuance can result in the entire portfolio being wiped out if the investment goes bad. Diversification…or the action of spreading investments among various securities or investments…can reduce this risk.

In a public sector defined contribution plan, the most common investments offered to participants are mutual funds that are, by design, diversified because they hold multiple securities designed to meet the same objective within a single portfolio. More conservative, fixed investments, such as stable value funds and fixed annuities are also diversified, as they typically contain securities or bonds from a variety of issuers.

Asset allocation is a strategy that diversifies an individual's investments beyond multiple securities and spreads dollars over several investment classes (stocks, bonds, cash, etc.). Research shows that it's the asset allocation of investments that accounts for nearly 92% of the variability of returns for the total portfolio holdings. This is because each asset class has distinct characteristics and, historically, reacts differently under the same market conditions.

By strategically diversifying investments by asset categories, declines in any one particular asset class can be offset and the fluctuations of the performance of the total portfolio may be reduced. Although these strategies are designed to mitigate the risks of fluctuation, the use of diversification and asset allocation does not guarantee that participants will be protected against loss in a declining market.

In addition to mitigating risk, an appropriate asset allocation strategy will reduce the likelihood of participants trying to time their buys and sells to the ups and downs of the market. This means that they won't be "buying high and selling low" when their timing is off, and their dollars will remain in the market during down cycles and benefit from rallies as they develop.

Asset allocation strategies are established to meet the individual needs of each investor based on their time horizon (the amount of time their dollars will be invested), risk tolerance and retirement income goals. As a result, there is no "one size fits all" when it comes to asset allocation strategies and the investment products available in your defined contribution plan should cover all of the core asset classes.

Overview of asset classes

Generally, the investments that are available to defined contribution plan participants will fall under three broad categories: stocks, bonds and cash and fixed rate equivalents. There are several subcategories within these segments that will also provide further diversification to participants to maximize potential returns while reducing risk. The following discusses the various asset categories and how they are generally used (or not) in a defined contribution plan.

Under ERISA 404(c), fiduciaries can potentially limit their liability for participants' decisions by following certain requirements when establishing the slate of investment options. Although public plans are not subject to ERISA, these can be used as guidelines. The basic requirements of 404(c) are:

- *offer a broad range of diversified core investment options with different risk or return characteristics*
- *allow participants to make changes to their investment decisions with a frequency that is appropriate for the options being offered; for example they must be allowed to redirect investments in at least three of the core investments at least once per quarter*
- *provide written information that they have the right to direct the investments held in their account*

Cash and fixed rate equivalents:

Most defined contribution plans will provide between one and three investment choices in this asset category. These investment vehicles are a core component of an appropriate asset allocation strategy to provide security and guarantee of investment principal. They generally are considered low risk and provide a small to modest return. These options include:

✓ Stable value funds are typically commingled funds that may invest in Guaranteed Investment Contracts (GICs), Bank Investment Contracts (BICs), synthetic GICs, Government-backed securities, and bonds. Maturities and duration of these portfolios are usually two to five years. Interest earned on this type of investment generally fluctuates on a daily basis.

✓ Fixed annuities are general account obligations offered by insurance companies. The insurance company guarantees the return of principal and typically provides a minimum guaranteed interest rate for the current quarter, current year, and/or life of the contract. These investments typically have a longer maturity period, with some securities maturing in 10, 20, or more years, and may include corporate mortgage bonds, corporate bonds, government securities, Treasury and Government-backed securities. Guarantees are subject to the claims-paying ability of the issuing insurance company.

✓ Bank or credit union savings options are normally insured by federal or state agencies. Investments are typically short-term and provide interest at current market rates that may be adjusted on a quarter, semi-annual or annual basis.

✓ Money market mutual funds are short-term investments that typically mature in less than one year. Investments generally include certificates of deposit, bank repurchase agreements, Treasury securities, and commercial paper. Interest earned will fluctuate on a daily basis. An investment in a money market or cash fund is not insured or guaranteed by the FDIC or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

Bonds:

Bond investment options provide participants with a low to moderate risk/return alternative. Bond mutual funds may invest in a mix of government and corporate bonds. These funds typically offer a higher rate of return than cash-type investments and carry a higher level of investment risk than cash equivalents. A defined contribution plan will typically offer between one and four bond investment choices that include the following.

✓ High-quality domestic bonds are usually investment-grade bonds that have been rated B or higher by leading bond rating agencies. These investments may be short-term (three years or less in duration), intermediate-term (three to 7.5 years in duration) or long-term (over 7.5 years in duration). Securities offered by government agencies are typically not subject to default risk. However, the Government and its agencies do not guarantee the fund's value and they may be subject to market risk caused by fluctuations in interest rates. Bonds issued by corporations may be subject to both default and market risk.

✓ High-yield domestic bonds are lower quality bonds offered by corporations. They are typically rated BB or lower by leading bond rating agencies. They have sometimes been referred to as "junk bonds", but can offer higher yields and higher potential for capital gains than high quality bonds.

Bond Ratings

Rating organizations (such as Standard & Poor's and Moody's) rate the level of risk of corporate, municipal and government issued securities based on current research.

The rating system indicates the likelihood that the issuer will default on interest or capital payments. Bond ratings generally range from AAA to D (default).

✓ International bonds are offered by governments or corporations of non-U.S. issuers. They may be subject to foreign currency, accounting and political risks that domestic bonds do not experience. Limited availability of information may also be a factor. However, international bonds may offer higher returns than domestic bonds and additional diversification within the bond asset class.

Stocks:

There are several categories of stock, or equity, investment options that typically are part of the plan's core investment menu to provide retirement plan participants with the ability to establish an appropriate asset allocation strategy in an attempt to diversify risk. Equities have higher investment risk than cash or bond securities. In exchange for assuming this risk, participants gain the potential for higher returns. Typically, plans offer between 4 and 15 equity funds within the following categories:

✓ Large cap stocks are issued by companies that have market capitalizations in excess of $8.5 billion dollars. They are typically the older, more established, and well-known companies. The Standard and Poor's 500 Index is a common proxy for the large cap asset class. General Motors Corporation and IBM are examples of large cap companies.

- ✓ Mid cap stocks are issued by companies that have market capitalizations between $1.5 billion and $8.5 billion. These stocks are from companies that are generally less-seasoned than those identified as large cap, but are more developed companies than small cap. The Standard & Poor's 400 MidCap Stock Index is a common proxy for the mid cap asset class. Tyson Foods and Caesars Entertainment are examples of mid cap stocks.

- ✓ Small cap stocks are issued by companies that have market capitalizations of less than $1.5 billion. They may be newer companies with higher debt and/or lower profit margins than other equities. Stocks of small or emerging companies may have less liquidity than those of larger established companies and may be subject to greater price volatility and risk than the overall stock market. The Standard & Poor's 600 SmallCap Index is a common proxy for the small cap asset class. Roto Rooter, Inc. and Yankee Candle are examples of small cap stocks.

- ✓ International stocks are issued by corporations that are traded on market exchanges outside the U.S. The Morgan Stanley Capital Incorporated Europe, Australasia, and Far East Index (MSCI EAFE) is a common proxy for international stock markets. Certain inherent risks may be associated with international investing. The Sony Corporation and Honda Motor Company are examples of international stocks.

Within the domestic and foreign equity classes, there are additional defined categories to delineate the investment philosophy or style of the mutual fund investments. The following provides an explanation of these three categories: growth, blend or value.

- ✓ *Growth funds* – these funds invest in stocks of companies that are experiencing a higher rate of growth than other companies. These types of companies may be paying a lower dividend rate or no dividends, but may have current earnings that are growing at a faster rate than the market. An example of a growth company would be Microsoft.

- ✓ *Value funds* – these options invest in stocks of companies that may be out of favor with the current market, but are typically more established companies that pay dividends at a rate higher than the market average. An example of a value stock would be the Exxon Mobil Corporation.

- ✓ *Blend funds* – these options use a combination of growth and value securities and produce returns that are more in line with the current market conditions. Typically, blend funds will vary their investments towards more growth than value, and vice versa, whenever the market is appearing to favor one style of investment over another.

There are also certain asset classes that are typically found in brokerage options or mutual fund windows, and not often included in the plan's core line-up. Specialty or sector funds such as real estate, precious metals, and financial stock funds are examples of sector funds. Non-diversified funds, those concentrating in a relatively small number of securities or specific sectors, may be subject to greater volatility than a more diversified investment and should be considered a vehicle for diversification and not a balanced investment program.

What should employers be doing to promote asset allocation?

In a defined contribution plan, participants are responsible for their own investment decisions. However, the role of the fiduciary is to make certain that suitable choices are available and sufficient education is provided so that employees understand the plan's investments and are able to make appropriate decisions.

Promoting asset allocation and providing information on how to establish a suitable investment strategy should be an integral part of this educational effort. Past research has shown us that many participants fail to make changes to their investment decisions after initial enrollment. Therefore, educational efforts are most critical when employees first establish their investment strategies at the time of enrollment. Asset allocation and its importance should continue to be reinforced through on-going participant communications (e.g., newsletters, brochures, Web sites, workshops, etc.).

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In determining a suitable asset allocation strategy, participants must understand their tolerance for risk in order to potentially receive higher long-term returns (e.g., can they stand to see short-term losses on their quarterly statements). Often, the plan's education will include a questionnaire as a self assessment tool to help participants understand and identify how much risk they are able to withstand.

Education will also typically include sample asset allocation portfolios that are geared to differing levels of risk and/or time horizons. Generally, there are at least three sample models – conservative, moderate, aggressive – to provide examples to participants on how to establish their own retirement portfolio. These asset allocation models usually incorporate the same asset classes, but vary in the amount allocated to each of the asset classes.

Once an asset allocation strategy is established, participants must monitor their accounts on an on-going basis. The gains and losses experienced in the underlying asset classes require participants to periodically rebalance their accounts to ensure the portfolio matches their original asset allocation strategy. Without this action, participants' investments will become more or less risky than originally planned.

To address this, the plan sponsor should ensure participants are reminded about rebalancing their account at least annually in participant newsletters, workshops, or other communication efforts. As an enhancement to education, administrators are also offering an automatic rebalancing service within the plan design. This type of service generally allows participants to establish a diversified portfolio for their account and the plan's recordkeeping system will automatically rebalance the dollars within their portfolio when it doesn't match the allocated percentages to each investment by a certain threshold (e.g., out of balance 5% or more).

This automated service replaces the need for participants to take action on an on-going basis. However, education efforts need to remind them that their allocation strategies should be periodically examined (particularly at certain life events, such as marriage, having children, retirement, etc.) to ensure it continues to be appropriate to meet their retirement income goals.

Many defined contribution plans are also offering lifecycle or lifestyle funds in their investment menus to provide a one-stop approach to asset allocation strategies. These mutual funds allow participants to select a single option that is geared to their risk tolerance or time horizon. The portfolio managers of these funds are responsible for maintaining the asset allocation. The following describes these investment vehicles.

- ✓ *Lifecycle funds –* these options provide age-based diversified portfolios that include a mix of asset classes that are designed to become more conservative overtime - as investors near retirement age and begin receiving distributions from their account. These investment choices are generally identified by retirement year (e.g., 2020, 2030, 2040 and so on).

An advantage of lifecycle funds is that, once-selected, participants do not need to take future action to become more conservative overtime, as the fund manager will automatically adjust the allocations as needed in consideration of the stated retirement year. One disadvantage is that these funds do not take into consideration individuals' risk tolerance and other assets that may contribute to the employee's retirement income. Failing to include assets, such as the pension plan and/or social security benefits to be paid to employees and their spouses, may result in the asset allocation being more conservative or aggressive than needed to meet future retirement income needs.

✓ *Lifestyle funds –* these options provide risk-based diversified portfolios that include a mix of asset classes that maintain a constant level of risk. This allows participants to make a single choice for their retirement investments based on their personal risk tolerance levels. Lifestyle options generally include choices that are conservative, moderate and aggressive.

An advantage of lifestyle funds is that once-selected, the manager of the fund rebalances the portfolios assets for the goal of maintaining a consistent asset allocation and risk level over time. One disadvantage is that they require investors to periodically review their risk tolerance to determine whether their financial situation has changed since their initial election. A marriage, change in job, health issues, or an inheritance may require a revision to the originally selected risk model.

An additional choice that public sector plans are beginning to explore are managed accounts, where a professional money manager makes investment decisions for the participant based on their individual needs (usually determined by answers to a questionnaire or information from the employer's record keeping system). This approach may be more costly than lifecycle or lifestyle options but will provide a personal investment plan geared to the individual needs of each participant based on both time horizon and risk tolerance levels.

Managed accounts will generally establish the asset allocation portfolio from the investment options offered within the plan's core menu. Alternatively, the manager may be permitted to use a broader list of investments to provide more flexibility in creating and revising the managed accounts. After the initial the portfolio has initially been established, participants should periodically review their time horizon and risk tolerance levels based on their current financial and life situations to determine if the basis for the managed account strategy has changed.

The above discusses three of the more common types of asset allocation strategies in public sector deferred compensation plans. Before deciding on an approach that is right for your plan and its participants, employers may want to explore other types of asset allocation funds that are available in the market today.

Current Trends

Research is showing that employees participating in defined contribution plans are beginning to understand asset allocation and the importance of diversifying their retirement portfolios. There is a long way to go, however, before plan sponsors and program administrators can claim their education programs are completely effective and successful in regard to asset allocation.

A recent study of public sector plans, ***America's Retirement Voice – Public Sector Retirement: Yesterday, Today and Tomorrow***,[1] confirmed that more employees are creating diversified asset allocation portfolios for their retirement accounts than ever before. In 1999, only 12% of participants in Section 457 deferred compensation plans used three or more asset classes in their retirement portfolio and 57% were invested in one asset class. At the end of 2003, the number invested in three or more asset classes grew to 32% while those with one asset class decreased to 44%.

When examining diversification by participant age, this study found the most notable improvements over the past five years in the youngest age groups…ages 18 to 25 and 26 to 35, with 39% and 36% increases respectively to the percentage of participants who are investing in three plus asset classes. As to gender differences, this study showed little difference between male and female participants in regard to asset allocation trends, although females tend to be more conservative in their investment choices for on-going deferrals.

This study also found that the use of asset allocation funds (i.e., lifestyle and lifecycle funds) is on the rise. At the end of 2003, 8% of participants were invested in this fund type. Younger participants (those 18 to 25 years old) were more likely than older participants to select this fund as their only investment option in their portfolio. Females in all age groups were more likely than male counterparts to use an asset allocation fund as their only investment choice.

Another recent study, the 2005 Retirement Confidence Survey,[2] found that employees who currently are not participating in their employer sponsored defined contribution plans are more likely to do so if asset allocation funds are an available option.

- ✓ 66% of non-participating workers said they would be more likely to participate if the plan offered lifecycle funds - funds that automatically provide workers a more conservative investment allocation as their retirement date approaches (21% much more likely; 44% somewhat likely)

- ✓ 49% said they would be more likely to participate if the plan offered lifestyle funds - a set of mutual funds with a pre-set mix of conservative, moderate and aggressive investments (13% much more likely; 36% somewhat likely)

- ✓ 35% said they would be more likely to participate in the plan offered managed accounts – where a professional financial manager made investment decisions based on the results of a questionnaire that the employee completes (15% much more likely; 20% somewhat likely)

The Retirement Confidence Survey also found that employees currently participating in an employer-sponsored plan that does not offer asset allocation funds would be interested in these options if they became available.

- ✓ 68% of participants said they would be likely to use lifecycle funds if offered by their plan (23% very likely; 45% somewhat likely)

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[1] America's Retirement Voice – Public Sector Retirement: Yesterday, Today and Tomorrow; Published by Nationwide Retirement Education Institute, April 2004 can be found on-line at www.nrsforu.com
[2] The 2005 Retirement Confidence Survey was conducted by the nonpartisan Employee Benefit Research Institute (EBRI) and Mathew Greenwald & Associates, Inc. and was underwritten by Nationwide.

- ✓ 67% said they would be likely to use lifestyle funds (21% very likely; 46% somewhat likely)
- ✓ 51% said they would be likely to use managed accounts (15% very likely; 36% somewhat likely)

In summary…*Employers need to pay attention to the asset allocation of plan assets*

Investment education is a critical component of defined contribution plans to ensure participants are able to make appropriate decisions in structuring their portfolios to reduce investment risk through asset allocation. Equally important, however, is the plan's investment menu.

Plan sponsors need to evaluate if their defined contribution plan's investment options are sufficient to meet their employees needs in establishing an asset allocation strategy. If not currently offered, it might be advisable for employers to consider exploring asset allocation options, such as lifecycle, lifestyle and/or managed accounts, to determine if they would be an appropriate addition to their plan's investment spectrum.

Asset allocation is important for employees to successfully invest for retirement. It is the employer's responsibility, as the plan's fiduciary, to make sure there is sufficient choice available to allow participants to establish asset allocation strategies that meet their individual needs.

About the authors…

Mary Willett, CRA, CRC, Willett Consulting, has more than 20 years experience in the field of public employee retirement benefits. She is the past director of the State of Wisconsin Supplemental Retirement Plans and started her own consulting business in 2002. She was the 2001/2002 President of NAGDCA and currently serves on the InFRE Board of Standards. She currently is working with Nationwide on plan sponsor education initiatives.

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